

EX PARTE OR LATE FILED

Anna-Maria Kovacs  
First Vice President-Research  
Janney Montgomery Scott  
60 State Street  
Boston MA 02109

Mr. Andrew Fishel  
Managing Director  
Federal Communications Commission  
1919 M Street NW, Room 852  
Washington DC 20554

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Federal Communications Commission  
Office of Secretary

April 8, 1997

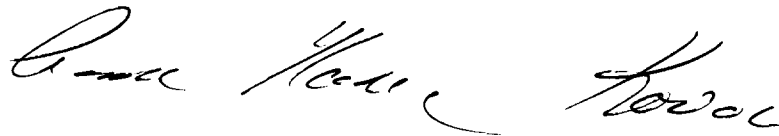
EX PARTE: Access Charge Reform CC Docket 96-262  
Federal State Joint Board on Universal Service CC Docket 96-45

Dear Mr. Fishel,

On February 26, 1997 a group of financial analysts, Frank Governali of Credit Suisse/First Boston, Richard Klugman of Goldman Sachs, Peter Kennedy of Morgan Stanley, Charles Shelke of Smith Barney, and I, met with Tom Boasberg, Robert Pepper, Greg Rosston, Jon Garcia, Elliot Maxwell, of the FCC staff and FCC Chairman Reed Hundt to discuss recent presentations by telecommunications companies to Wall Street analysts and investor expectations of upcoming regulatory decisions in the access charge reform and universal service dockets listed above. I have enclosed copies of the publications that the analysts issued subsequent to the meeting. In accordance with the Commission's rules, an original and two copies of this notice are being filed.

Please let me know if you have any questions.

Sincerely yours,



James Montgomery Scott

**Morning Meeting Comments**

FEBRUARY 27, 1997

TELECOM INDUSTRY

UPDATE

ANNA-MARIA KOVACS  
KRISTIN BURNS  
TELECOM INDUSTRY

Five sell-side analysts, including myself, met yesterday, briefly, with Chairman Hundt, and at much greater length with his staff. The goal of the meeting was to get Wall Street's reaction to the FCC's current thinking about access reform and universal service, and specifically to test our reaction to the ideas in Chairman Hundt's speech to NARUC on February 25<sup>th</sup>.

In his speech, Chairman Hundt reiterated the principles of the August Interconnection Order and focused on some of the specific items that had been raised in the access Notice of Proposed Rulemaking (NPRM, 12/24/96). He stated that he considers infrastructure competition most desirable, and believes the best way to achieve that is to enable new entrants to share incumbents' facilities via resale, unbundling, and interconnection. He reaffirmed his commitment to universal service, and his belief that access reform must be done simultaneously with universal service. Specifically he stated:

While he does not believe in separate federal and state Funds, he is inclined to avoid jurisdictional litigation by focusing the federal Universal Service Fund (USF) on interstate revenues only. We believe that is likely to result in a fairly small federal USF and to be helpful to companies like Ameritech that are net contributors to the Fund, and not helpful to others like BellSouth or GTE that are large net takers from the Fund. He continues to be committed to restructuring access charges in accordance with underlying costs, converting fixed costs currently recovered on a per-minute basis to flat rates. He suggested the name FEBC, flat equitable rate charge, for the flat rate. He suggested that it might be imposed more quickly or to a greater degree on second residential lines or on multibusiness lines than on first residential lines.

He asked for comment on speed of transition in moving access charges to forward looking costs, and indicated that it might make sense to move to a market-based system more rapidly on originating traffic, where the consumer has a choice about his local carrier than at the terminating end, where the consumer is at the mercy of someone else's choice. He also indicated that initial access rate cuts at the originating end might be smaller than at the terminating end.

Like the access cuts, the USF may be phased in. In considering recovery of embedded costs in this simultaneous process, he believes the profits local companies make from, wireless, publishing and long-distance should be considered as offsets to the "takings" from the core business.

He also commented with regard to Bell in-region long distance entry (section 271 entry) that he looks to the states for a record on competition in the state and that "The quality of the record compiled by each state commission may be more important than the vote that commission casts."

The sell-side group, almost all of whom currently are recommending REOCs and other LBCs rather than major long distance players, was asked to comment on several points specifically:

On our expectations for the financial magnitude of access cuts net of USF funding by DXCs: everyone seems to expect an initial cut of \$1-2 billion in year one, with similar cuts for several years, for a total of \$7 billion in 5 years. No one in the group would change ratings over an initial cut of \$3 billion, as long as the 5 year total remains the same or less.

This information is sent to you for informative purposes only and is not meant to be construed as a representation by us or for an offer to sell or purchase of an offer to buy any securities. The financial information given herein is taken from sources which we believe to be reliable, but is not guaranteed by us as to accuracy or completeness. The opinions expressed should be given only such weight as appropriate warrant. This firm and its officers and/or members of their families may have a position in the securities mentioned and they may purchase or sell securities of such companies from time to time in the open market or otherwise. Additional information relative to the subject discussed is available to our clients.

On the FERC: all feel that the ability to flat-rate per minute charges would be helpful to AT&T and other DCEs as long as they could pass the charge through any way it wants. It would enable it them to lower per-minute rates, which is helpful to high-end users, and place a flat charge of small users. We also agreed that passing the FERC through the long-distance bill is likely to result in more protest from consumers than passing it through the local bill, since many consumers make little use of long distance. Our group agreed that raising the SLC would be unpopular with Congress but felt it would work better with consumers themselves.

The group was split on our expectations of when 271 entry would occur, with most of us expecting most of the entry in '98. The supporters of Bell stocks were clear that their support of those stocks relies most on their belief that significant competition in the local market will develop slowly, much more slowly than the Bells' entry into long distance in-region.

What we believe the FCC took away from the meeting was a sense that access cuts in the \$1-3 billion range this year would be accepted calmly by the stock market, and that the FERC would be good for both local telcos and long distance carriers, but not for pure CAPs.

We continue to expect initial access cuts in the \$1-2 billion range, net of universal service funding. They may well focus more on the terminating than originating end. We expect additional prescriptive cuts over the next several years unless the market itself takes down access rights significantly. We expect a small federal USP.

We continue to recommend purchase of AT&T (T-441).

**James Montgomery Scott**

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JANNEY MONTGOMERY SCOTT

FEBRUARY 27, 1997

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We continue to recommend purchase of AT&T (T-641).

# MORGAN STANLEY

## Equity Research

### Briefing Note

#9 ATT, BEL, BLS, FON, GST, ICIX, ICG, IDXC, MCIC, MCLD, NYN, PAC, SBC, T, TCGI, USW, WCI, WCOM, US  
Telecommunications Services (I/TEL): Meeting With the FCC  
Stephanie Comfort (303) 740-6695  
Peter Kennedy (212) 761-8033

Date: March 5, 1997  
Type: Industry Overview

#### KEY POINTS

Yesterday we met with the FCC to discuss access reform and universal service. The FCC was looking for Wall Street expectations and reactions to various outcomes.

Although the process is still fluid, we believe this meeting combined with our interpretation of Chairman Reed Hundt's recent speech to the National Association of Regulatory Utility Commissioners has given us a better sense, directionally, of where the Commission is going.

As you recall, the 1996 Telecom Act required that the Universal Fund, an explicit subsidy fund, be enhanced to support telecommunications services for low income households, high cost areas and subsidize public schools, libraries etc. Today these subsidies are primarily achieved through implicit support mechanisms (access revenues). The goal of the FCC has been to restructure the support mechanisms from implicit to explicit subsidies. This is why access reform and universal service are so intertwined.

#### Access Reform

According to FCC reports, in 1995 there was \$31B for in access charges paid to the local exchange providers. This consists of \$7.1B in enduser revenues with the remaining \$24b from switched and special access. Switched access revenues are derived from originating and terminating per minute access charges paid by the inter exchange carriers (IXCs). Today, traffic sensitive access rates are just below \$0.03 per minute. These access rates have historically never been based on cost but have been used to subsidize other high cost components of the local network. The FCC intends to drive inter-state access rates down to cost over some time period. With current estimates for forward

looking economic costs coming in at \$0.004-\$0.01, there is a significant gap between current tariffs and cost projections.

We believe this reform will be realized through two methods, restructuring and straight reductions.

**Restructuring** - One of alternatives mentioned was to convert variable carrier common line (CCL) charges into fixed line charges. A portion of access rates today (\$0.004-\$0.02) are what are known as carrier common line charges. These charges were created to support the high cost of the local loop. Although the charges are traffic sensitive, the actual costs are not traffic sensitive and should indeed be a fixed cost. Instead of paying a per minute charge, L.D providers will pay a fixed cost per pre-subscribed line.

#### Implications

- We believe this benefits Long Distance Providers especially those with high end customers. By placing a greater portion of variable cost into fixed costs, interexchange providers will be able to offer price incentives to stimulate volume demand while keeping a greater portion of the costs fixed.
- For the CLECS, we believe this is slightly negative in the short term. By placing more of the revenue into fixed per line revenues, it displaces the cream skimming of high end users.
- This restructuring is slightly favorable for the RBOCs because this does displace cream skimming but it also reduces the benefit of access volume growth in the network.

#### Reductions -

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## MORGAN STANLEY

We also believe there will be substantial reductions in access rates driving the traffic sensitive portion down to \$0.005-\$0.01 range over the next three to five years. We believe that these rates will be reduced through a combination of regulatory cuts and prescribed minimums for market based reduction, with particular emphasis on terminating access.

#### Implications

- Again this is a positive for the long distance providers to the extent retail prices remain stickier and do not decline as fast as access.

- For the CLECs this is a slight negative because of their traditional CAP business which relied heavily on access rates. The CLEC or Dial tone business is less impacted because of the diverse revenue streams of local, toll and access.

- The RBOCs should feel pressure from any significant cuts in access. It is their most profitable revenue, with 80% + margins. To the extent that the access reductions are not supplemented with Universal Service payments, these reductions will virtually all fall to the bottom line.

#### Universal Service Fund

The exact size of the fund has yet to be determined, but it appears to be substantially less than the present implicit fund. Currently the Commission estimates that there is \$23B in access charges that are flowing to incumbent local exchange carriers (ILECs) from IXCs. The contention that has arisen is how much of the access revenues go towards real costs and how large should the new explicit subsidy be. The ILECs believe they should be kept whole or close to whole, while the IXCs think the explicit fund should be \$5-10B. We believe the Street is anticipating the fund will end up in the \$10B-15B.

The FCC is currently in negotiations with the State PUCs on just how to approach the fund. Will there be two separate funds (Intra-state and Interstate) or one large universal fund? The FCC's position today, is that unless there is consensus among the States, the FCC will just run an interstate universal fund and let the States fend for themselves on the shortfalls. We believe the FCC is a bit shy after the State

lawyers over the interconnection rules but we also believe this is a bit of posturing by the FCC. The rural states with less telecommunications revenues and higher costs structures would be better off with one Federal Fund. Because of the revenue concentration in the top 10 states, we believe that the majority of States would benefit from one central fund.

**Fixed Charge** - With the reductions in access, the FCC has to derive another payment mechanism to support the universal fund. The mechanism that is currently being discussed is a flat rate, called the flat and equitable rate charge (FERC), based on pre-subscribed lines. The charge will probably not be equal for all lines, multi-lines and second lines will probably have premiums attached.

**FCC uses Interstate Revenues to Fund the Federal Portion of Universal Funds.** If the FCC goes with only interstate revenues, no local or intrastate revenues will be affected (taxed) by the FCC Fund.

#### Net Impact

If the FCC remains on its present track, with the interstate fund only, we could see the ILECs' subsidy pool shrink by \$5B to \$10B over the next five years. This does not account for any elasticity/growth in the market or any State support mechanisms.

#### LD

LD players appear to be the winners in access reform. Although the timing and magnitude is still unclear, we believe that net payments to the ILECs will decline.

#### CLECs

We see the impact to the CLECs as slightly negative but above expectations. The CLECs will be impacted by access reductions, but these reductions will be phased in and will be more focused on the terminating access reductions which impact the ILECs more than the CLECs. In regards to universal services contributions, if the FCC decides on an interstate fund only, CLECs will not have to contribute any revenue from its core base. Those CLECs with a large portion of LD revenues will be beneficiaries of this reform.

**ILECs**

Access rate reductions should not lose profitable revenues with no complete offset by universal service. RBOCs will need to rely on States for rebalancing or state run universal service funds. On the positive side, the market was eating into the high end business access and would eventually bring down rates with no rebalancing. Flat rates will ease some of the cross subsidizing.

**Table 1****Possible Elements of Access Charge Reform and Universal Service Fund Proposal From FCC**

Possible Proposal	ILEC	Implications Long Dist	CLIC
(1) Access reductions will be a combination of an upfront cut (possibly \$1-\$2 billion) and a mechanism to drive down access to cost over a pre-determined period of time (i.e. 3-5 yrs)	negative but better than a flat cut	positive	negative (but better than a flat cut)
(2) As access charges are driven down, some usage based charges that the ILECs currently receive from long distance carriers will be converted to flat-rate charges.	positive	positive	negative
(3) The terminating access charges could be driven down faster than originating access charges since there is more market pressure (no competition) on originating than on terminating access (customers don't choose who terminates their calls).	negative	positive	positive
(4) The FCC is considering running just an interstate universal service fund which would be smaller than currently expected, leaving it up to the individual states to deal with the interstate portion of the fund.	negative	positive	positive
Net Net	Negative	Positive	Neutral, better than scenario states are anticipating.

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As you recall, the 1996 Telecom Act required that the Universal Fund, an explicit subsidy fund, be enhanced to support telecommunications services for low income households, high cost areas and subsidize public schools, libraries etc. Today these subsidies are primarily achieved through implicit support mechanisms (access revenues). The goal of the FCC has been to restructure the support mechanisms from implicit to explicit subsidies. This is why access reform and universal service are so intertwined.

#### Access Reform.

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looking economic costs coming in at \$0.004-\$0.01, there is a significant gap between current tariffs and cost projections.

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#### Implications

- We believe this benefits Long Distance Providers especially those with high end customers. By placing a greater portion of variable cost into fixed costs, interexchange providers will be able to offer price incentives to stimulate volume demand while keeping a greater portion of the costs fixed.

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We also believe there will be substantial reductions in access rates driving the traffic sensitive portion down to \$0.005-\$0.01 range over the next three to five years. We believe that these rates will be reduced through a combination of regulatory cuts and prescribed minimums for market based reduction, with particular emphasis on terminating access.

#### Implications

- Again this is a positive for the long distance providers to the extent retail prices remain stable and do not decline as fast as access.

- For the CLECs this is a slight negative because of their traditional CAP business which relied heavily on access rates. The CLEC or Dial tone business is less impacted because of the diverse revenue streams of local, toll and access.

- The RBOCs should feel pressure from any significant cuts in access. It is their most profitable revenue, with 80% + margins. To the extent that the access reductions are not supplemented with Universal Service payments, these reductions will virtually all fall to the bottom line.

#### Universal Service Fund

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**FCC may Increase Revenues to Fund the Federal Portion of Universal Funds.** If the FCC goes with only interstate revenues, no local or intrastate revenues will be affected (taxed) by the FCC Fund.

#### Net Impact

If the FCC remains on its present track, with the interstate fund only, we could see the ILECs' subsidy pool shrink by \$3B to \$10B over the next five years. This does not account for any elasticity/growth in the market or any State support mechanisms.

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**ILECs**

Access rate reductions should eat into profitable revenues with no complete offset by universal service. REOCs will need to rely on States for rebalancing or state run universal service funds. On the positive side, the market was eating into the high end business access and would eventually bring down rates with no rebalancing. Flat rates will ease some of the cream skimming.

**Table 1****Possible Elements of Access Charge Reform and Universal Service Fund Proposal From FCC**

Possible Proposal	ILEC	Implications Long Dist	CLIC
(1) Access endowment will be a combination of an upfront out (possibly \$1-\$2 billion) and a mechanism to drive down access to cost over a pre-determined period of time (i.e. 3-5 yrs)	negative (not better than a flat out)	positive	negative (not better than a flat out)
(2) As access charges are driven down, some usage based charges that the ILECs currently receive from long distance carriers will be converted to flat-rate charges.	positive	positive	negative
(3) The terminating access charges could be driven down faster than originating access charges since there is more market pressure (no competition) on originating than on terminating access (customers don't choose who terminates their calls).	negative	positive	positive
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Net Net	Negative	Positive	Neutral, better than scenario states are anticipating

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# MORGAN STANLEY

## Equity Research

### Briefing Note

#9 ATT, BEL, BLS, FON, GST, ICIX, ICC, IXC, MCIC, MCLD, NYN, PAC, SBC, T, TCCI, USW, WCI, WCOM, US  
 Telecommunications Services (I/TEL): Meeting With the FCC  
 Stephanie Canforst (303) 740-6695  
 Peter Kennedy (212) 761-8033

Date: March 5, 1997  
 Type: Industry Overview

#### KEY POINTS

Yesterday we met with the FCC to discuss access reform and universal service. The FCC was looking for Wall Street expectations and reactions to various outcomes.

Although the process is still fluid, we believe this meeting combined with our interpretation of Chairman Reed Hundt's recent speech to the National Association of Regulatory Utility Commissioners has given us a better sense, directionally, of where the Commission is going.

As you recall, the 1996 Telecom Act required that the Universal Fund, an explicit subsidy fund, be enhanced to support telecommunications services for low income households, high cost areas and subsidize public schools, libraries etc. Today these subsidies are primarily achieved through implicit support mechanisms (access revenues). The goal of the FCC has been to restructure the support mechanisms from implicit to explicit subsidies. This is why access reform and universal service are so intertwined.

#### Access Reform.

According to FCC reports, in 1995 there was \$31B for in access charges paid to the local exchange providers. This consists of \$7.1B in enduser revenues with the remaining \$24b from switched and special access. Switched access revenues are derived from originating and terminating per minute access charges paid by the inter exchange carriers (IXCs). Today, traffic sensitive access rates are just below \$0.03 per minute. These access rates have historically never been based on cost but have been used to subsidize other high cost components of the local network. The FCC intends to drive inter-state access rates down to cost over some time period. With current estimates for forward

looking economic costs coming in at \$0.004-\$0.01, there is a significant gap between current tariffs and cost projections.

We believe this reform will be realized through two methods: restructuring and straight reductions.

**Restructuring** - One of alternatives mentioned was to convert variable carrier common line (CCL) charges into fixed line charges. A portion of access rates today (\$0.004-\$0.02) are what are known as carrier common line charges. These charges were created to support the high cost of the local loop. Although the charges are traffic sensitive, the actual costs are not traffic sensitive and should indeed be a fixed cost. Instead of paying a per minute charge, LD providers will pay a fixed cost per pre-subscribed line.

#### Implications

- We believe this benefits Long Distance Providers especially those with high end customers. By placing a greater portion of variable cost into fixed costs, Interchange providers will be able to offer price incentives to stimulate volume demand while keeping a greater portion of the costs fixed.

- For the CLECS, we believe this is slightly negative in the short term. By placing more of the revenue into fixed per line revenues, it discourages the cream skimming of high end users.

- This restructuring is slightly favorable for the RBOCs because this does discourage cream skimming but it also reduces the benefit of access volume growth in the network.

#### Reductions -

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We also believe there will be substantial reductions in access rates driving the traffic sensitive portion down to \$0.005-\$0.01 range over the next three to five years. We believe that these rates will be reduced through a combination of regulatory ease and prescribed mechanisms for market based reduction, with particular emphasis on terminating access.

### Implications

- Again this is a positive for the long distance providers to the extent retail prices remain stable and do not decline as fast as access.

- For the CLBCs this is a slight negative because of their traditional CAP business which relied heavily on access rates. The CLBC or Dial tone business is less impacted because of the diverse revenue streams of local, toll and secret.

- The RBOCs should feel pressure from any significant cuts in access. It is their most profitable revenue, with NOB + margins. To the extent that the access reductions are not supplemented with Universal Service payments, these reductions will virtually all fall to the bottom line.

### Universal Service Fund

The exact size of the fund has yet to be determined, but it appears to be substantially less than the present implicit fund. Currently the Commission estimates that there is \$23B in access charges that are flowing to incumbent local exchange carriers (ILECs) from DRCs. The contention that that arises is how much of the access revenues go towards real costs and how large should the new explicit subsidy be. The ILECs believe they should be large whole or close to whole, while the DRCs think the explicit fund should be \$5-10B. We believe the Secret is anticipating the fund will end up in the \$10B-15B.

The FCC is currently in negotiations with the State PUCs on just how to approach the fund. Will there be two separate funds (Inter-state and Intra-state) or one large universal fund? The FCC's position today is that unless there is consensus among the States, the FCC will just run an interstate universal fund and let the States fend for themselves on the shortfalls. We believe the FCC is a bit shy after the Sosa

levering over the interconnection rules but we also believe this is a bit of posturing by the FCC. The rural states with less telecommunications revenues and higher costs structures would be better off with one Federal Fund. Because of the revenue concentration in the top 10 states, we believe that the majority of States would benefit from one central fund.

**Fixed Charge** - With the reductions in access, the FCC has to devise another payment mechanism to support the universal fund. The mechanism that is currently being discussed is a flat rate, called the flat and equitable rate charge (FERAC), based on pre-subscribed lines. The charge will probably not be equal for all lines, multi-line and second lines will probably have premiums attached.

FCC uses Incremental Revenues to Fund the Federal Portion of Universal Funds. If the FCC goes with only interstate revenue, no local or interstate revenues will be affected (used) by the FCC Fund.

### Net Impact

If the FCC remains on its present track, with the interstate fund only, we could see the ILECs' subsidy pool shrink by \$2B to \$10B over the next five years. This does not account for any elasticity/growth in the market or any fixed support mechanisms.

### LD

LD players appear to be the winners in access reductions. Although the timing and magnitude is still unclear, we believe that net payments to the ILECs will decline.

### CLBCs

We see the impact to the CLBCs as slightly negative but above expectations. The CLBCs will be impacted by access reductions, but these reductions will be phased in and will be more focused on the terminating access reductions which impact the ILECs more than the CLBCs. In regards to universal services contributions, if the FCC decides on an interstate fund only, CLBCs will not have to contribute any revenue from its core base. Those CLBCs with a large portion of LD revenues will be beneficiaries of this reform.

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**ILECs**

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Equity Research  
Broadcast - All Offices  
Code: A

Analyst: Frank J. Governali, CFA  
Industry: Telecom Services  
Telephone: (207) 780-6210  
Date: March 10, 1997

Industry: Telecom Services  
Subject: Meeting with FCC Staff & Chairman To Discuss Access Reform and Universal Service  
Ratings: No Change

### Summary

On May 8 the FCC must issue its order on Access Charge Reform and Universal Service funding. The FCC wants to keep the Street's expectations in line with reality, and to insure it is aware of expectations - thus meetings have been conducted with the Street. The FCC is not telling people what it intends to do, but rather reviewing the various options. Our meeting yesterday provided no basis to change our current view on access charge and universal service reform: we continue to believe that access reform will trim annual LEC revenues by \$5 to \$7 billion (net), by the end of a 3 to 5 year transition period. Universal service fund would be \$6 to \$8 billion. Reformed access charges will be comprised of fixed per-line charge, combined with usage sensitive fee.

- **Meeting with FCC Staffers with brief visit by Chairman Hundt.** Yesterday, February 26, we, along with four other sell-siders, met with FCC senior staffers and briefly with Chairman Reed Hundt. The avowed purpose of the meeting was to gauge the expectation of Wall Street to various policy options in the FCC arsenal regarding access reform and universal service. The FCC has been holding these meetings, and will hold others, to ensure it is adequately considering all options in its policy development, and to insure the Street is not in left field as it relates to expected outcomes. This is a smart move by the FCC, of course assuming, federal policy is not being dictated by stock prices - which of course it is not. By May 8 the FCC is required to come up with its order on access charge reform and universal service funding. The task is daunting and the implications profound for the industry. These issues get at the very heart of U.S. telecom policy and will be two of the prime determinants of whether or not competition successfully enters the local arena. (The others are the interconnect rules and the timing of RBOC entry into long distance.)
- **Hundt Lays Out Policy Principles In Presentation to NARUC On February 25.** On Tuesday Chairman Hundt presented and outline of policy priorities and principles to the National Association of Regulated Utility Commissioners. It is useful to consider his points, because it was this speech that was the backdrop for our discussion with the FCC officials on Wednesday. First, Hundt reinforced the notion that access charges need to get down to forward looking costs. Second, that the recovery of costs had to be done on a basis that encouraged competition and reflected the economic incurrence of cost. Thus, he supported the joint Board recommendation to collect access on both a fixed and variable basis - a fixed monthly per line charge combined with a lower usage element. Third, he reconfirmed his position that the LECs should not be assured of fully recovering historic costs in access reform or interconnection. Fourth, he reconfirmed his commitment to a transitional implementation of reduced access charges (not a dislocating flash cut).
- **No suggestion of revenue neutral reform of access charges.** Recently there have been stories circulating that access reform will end up being a "revenue-neutral" transition for the LECs. We definitely did not hear this yesterday. There can be several interpretations of what revenue neutral means. By our definition, it means that access charges themselves are changed in such a way as to not effect the net revenue collected for access. Thus, based on our discussion yesterday, we continue to believe that access charges will be cut, producing a net reduction in revenue to the LECs on an annual basis of \$5 to \$7 billion by the end of a three to five year transition period. We expect the 1997 cut, and subsequent additional cuts to total \$1 to \$2 billion, adding up to the total \$5 to \$7 billion.

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We have not and do not view this level of access cuts to be dramatic. This level of cuts is in line with the revenue reductions absorbed by the LEC industry in their annual price cap adjustments. This level of cuts certainly holds down revenue growth, but it in no way compromises their ability to fund capital investment and maintain the local networks, which is a key concern of regulators and politicians.

The FCC is committed to changing the way access charges are collected. The agency wants to make the method of collection more reflective of the way in which costs are incurred by the LECs. Thus, it wants to get away from collecting the access charges purely on a usage sensitive basis. The FCC is supporting the Joint Board's recommendation to make access charge collection a combination of a fixed monthly per line fee, and a smaller usage sensitive component. Just as access charges today are collected directly from the long distance carriers, these newly formulated access charges will still be collected directly from long distance carriers. And, just as long distance carriers make their own decisions today on how to recover their access costs in pricing to end users, they will do the same in the future. Thus, if the per line charge ends up being \$2 per month for standard telephone lines, (a reasonable level) the long distance carriers would be able to make the choice whether to pass this fee directly to consumers, or to somehow mark it in their long distance rates.

- **Implications of A Fixed Per Line Charge Combined With a Usage Sensitive Component.** The change in the way access charges are collected has positive and negative consequences for both LECs and new entrants. For the LECs, the positive is that it will remove some of the opportunity for competitors to cherry pick high end customers, who generate a lot access revenues through long distance calling. The negative is that with a smaller usage sensitive charge the LECs won't enjoy as much of a revenue pick-up with volume growth. For CAPs the new regime would take away some of the opportunity for cherry picking at the top. But as Reed Hundt said yesterday: "we want to turn CAPs into CLECs" (Competitive Local Exchange Carriers.) The opportunity for CLECs remains undiminished by this change. Similarly, for long distance carriers, eager to become CLECs this change would not be significant. For long distance carriers the key issue is the size of the access revenue cut, not so much its distribution. However, if long distance carriers have to pay a high per-line fee, then very low end customers become unattractive. If a current pre-subscribed customers makes little to no long distance calls, then the carrier will want to drop this customer, since the revenue might not even cover the per line fee.
- **Implications For Stocks.** We continue to believe the growth outlook for the RBOCs is a 3% to 7% growth rate. This is based on the level of access cuts described above, entry into long distance in the second half of 1998, and competitive pressures starting in the second half of 1997. With this outlook, we think the RBOCs have gotten ahead of themselves recently. On the long distance side, there is no "group call." Its company specific. This is also true for the CLECs. Companies that can operate successfully in the current environment, and transition successfully to full service operators will be winners.

**Excerpts From The Chairman's Speech :** we've lifted quotes from Reed Hundt's speech below. We think these comments can help understand the FCC's current position on a variety of topics.

*Pro-Competition ... means we want to promote all competitors and competitive strategies, even-handedly and indifferently, as opposed to following the United Kingdom model and promoting specifically and unevenly alternative infrastructure development by the cable industry, or a single facilities-based long distance carrier like Mercury*

*Our choice of being pro-competition instead of being pro-any specific competitor is why we at the state and federal level are supposed to guarantee all three of the basic rights of new entrants under the Act: buying at wholesale, leasing elements, and interconnecting from new facilities. Effective enforcement of all three rights is necessary to expedite the entry of new competitors into the local exchange and access markets.*

*Our vigilance in enforcing these rights is essential because the scope of the challenge facing new entrants is quite broad. In every single existing service territory the market is dominated by one company - the historic monopolist.*

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reflect the way in which costs are incurred by LECs. That's what would happen in a competitive market and thus we should seek to emulate this result in the absence of such competition. Where and when the market for a particular access service is workably competitive, access prices should be set by that market, not by government. The big question in access reform is not our target, but how - and how fast - we get there.

This inefficient pricing (of access) discourages broad entry by new entrants (because revenues are concentrated in high volume users) and deters usage of long distance (because it is priced artificially high).

To get from where we are today to where we would like to be, the Joint Board thought we should move some traffic sensitive charges to flat rate charges imposed on IXCs by the LECs. We're calling this the flat and equitable rate charge or FERC...

...We still have to decide how much usage-based charges should be reduced on what we call Day One, the effective date for the changes in our access reform order, and how long we should take to phase in the rest of the reduction required to get to forward looking costs.

Nor is it obvious that FERC ought to be imposed on all access lines.

In terms of rate levels, we may wish to have different approaches for originating and terminating access charges. There seems to be broad consensus among economists that originating access rates will experience significantly more market pressure than terminating access.

The combined effect of the changes I'm discussing here today is to take a significant step toward getting access charges to cost immediately, with the bulk of additional reductions coming later, over time.

As to future access reductions, it will be critical to set in motion a predictable process in our order that will reduce access to forward looking economic cost within a reasonable time period.

...we also intend to address the question of LEC recovery of historic costs...I do not believe however, that we should begin the inquiry into the historic cost issue with the supposition that the LEC is necessarily guaranteed as a matter of law a complete certainty of recovering all such investment. Takings is certainly one of our concerns here, but we must not forget "givings". Let me mention three: first, giving the LECs cellular licenses worth billions; second, giving LECs yellow pages publishing opportunities (also worth billions); and third giving LECs the opportunity to enter long distance, where they can leverage their regulated local asset.

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FIRST BOSTONEquity Research  
Broadcast - All Offices  
Code: AAnalyst: Frank J. Governall, CFA  
Industry: Telecom Services  
Telephone: (207) 780-6210  
Date: March 10, 1997

**Industry:** Telecom Services  
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*Our vigilance in enforcing these rights is essential because the scope of the challenge facing new entrants is quite broad. In every single existing service territory the market is dominated by one company - the historic monopolist.*

*...I think that our target is clear: over time lowering traffic sensitive interstate access charges to forward looking cost and restructuring the cost recovery such that prices charged*

We have not and do not view this level of access cuts to be dramatic. This level of cuts is in line with the revenue reductions absorbed by the LEC industry in their annual price cap adjustments. This level of cuts certainly holds down revenue growth, but it in no way compromises their ability to fund capital investment and maintain the local networks, which is a key concern of regulators and politicians.

The FCC is committed to changing the way access charges are collected. The agency wants to make the method of collection more reflective of the way in which costs are incurred by the LECs. Thus, it wants to get away from collecting the access charges purely on a usage sensitive basis. The FCC is supporting the Joint Board's recommendation to make access charge collection a combination of a fixed monthly per line fee, and a smaller usage sensitive component. Just as access charges today are collected directly from the long distance carriers, these newly formulated access charges will still be collected directly from long distance carriers. And, just as long distance carriers make their own decisions today on how to recover their access costs in pricing to end users, they will do the same in the future. Thus, if the per line charge ends up being \$2 per month for standard telephone lines, (a reasonable level) the long distance carriers would be able to make the choice whether to pass this fee directly to consumers, or to some how mask it in their long distance rates.

- **Implications of A Fixed Per Line Charge Combined With a Usage Sensitive Component.** The change in the way access charges are collected has positive and negative consequences for both LECs and new entrants. For the LECs, the positive is that it will remove some of the opportunity for competitors to cherry pick high end customers, who generate a lot access revenues through long distance calling. The negative is that with a smaller usage sensitive charge the LECs won't enjoy as much of a revenue pick-up with volume growth. For CAPs the new regime would take away some of the opportunity for cherry picking at the top. But as Reed Hundt said yesterday: "we want to turn CAPs into CLECs" (Competitive Local Exchange Carriers.) The opportunity for CLECs remains undiminished by this change. Similarly, for long distance carriers, eager to become CLECs this change would not be significant. For long distance carriers the key issue is the size of the access revenue cut, not so much its distribution. However, if long distance carriers have to pay a high per-line fee, then very low end customers become unattractive. If a current pre-subscribed customer makes little to no long distance calls, then the carrier will want to drop this customer, since the revenue might not even cover the per line fee.
- **Implications For Stocks.** We continue to believe the growth outlook for the RBOCs is a 3% to 7% growth rate. This is based on the level of access cuts described above, entry into long distance in the second half of 1996, and competitive pressures starting in the second half of 1997. With this outlook, we think the RBOCs have gotten ahead of themselves recently. On the long distance side, there is no "group call." Its company specific. This is also true for the CLECs. Companies that can operate successfully in the current environment, and transition successfully to full service operators will be winners.

**Excerpts From The Chairman's Speech :** we've lifted quotes from Reed Hundt's speech below. We think these comments can help understand the FCC's current position on a variety of topics.

*Pro-Competition ... means we want to promote all competitors and competitive strategies, even-handedly and indifferently, as opposed to following the United Kingdom model and promoting specifically and unevenly alternative infrastructure development by the cable industry, or a single facilities-based long distance carrier like Mercury*

*Our choice of being pro-competition instead of being pro-any specific competitor is why we at the state and federal level are supposed to guarantee all three of the basic rights of new entrants under the Act: buying at wholesale, leasing elements, and interconnecting from new facilities. Effective enforcement of all three rights is necessary to expedite the entry of new competitors into the local exchange and access markets.*

*Our vigilance in enforcing these rights is essential because the scope of the challenge facing new entrants is quite broad. In every single existing service territory the market is dominated by one company - the historic monopolist.*

*...I think that our target is clear: over time lowering traffic sensitive interstate access charges to forward looking cost and restructuring the cost recovery such that prices charged*

reflect the way in which costs are incurred by LECs. That's what would happen in a competitive market and thus we should seek to emulate this result in the absence of such competition. Where and when the market for a particular access service is workably competitive, access prices should be set by that market, not by government. The big question in access reform is not our target, but how — and how fast—we get there.

This inefficient pricing (of access) discourages broad entry by new entrants (because revenues are concentrated in high volume users) and deters usage of long distance (because it is priced artificially high).

To get from where we are today to where we would like to be, the Joint Board thought we should move some traffic sensitive charges to flat rate charges imposed on IXCs by the LECs. We're calling this the flat and equitable rate charge or FERC...

...We still have to decide how much usage-based charges should be reduced on what we call Day One, the effective date for the changes in our access reform order, and how long we should take to phase in the rest of the reduction required to get to forward looking costs.

Nor is it obvious that FERC ought to be imposed on all access lines.

In terms of rate levels, we may wish to have different approaches for originating and terminating access charges. There seems to be broad consensus among economists that originating access rates will experience significantly more market pressure than terminating access.

The combined effect of the changes I'm discussing here today is to take a significant step toward getting access charges to cost immediately, with the bulk of additional reductions coming later, over time.

As to future access reductions, it will be critical to set in motion a predictable process in our order that will reduce access to forward looking economic cost within a reasonable time period.

...we also intend to address the question of LEC recovery of historic costs...I do not believe however, that we should begin the inquiry into the historic cost issue with the supposition that the LEC is necessarily guaranteed as a matter of law a complete certainty of recovering all such investment. Takings is certainly one of our concerns here, but we must not forget "givings". Let me mention three: first, giving the LECs cellular licenses worth billions; second, giving LECs yellow pages publishing opportunities (also worth billions); and third giving LECs the opportunity to enter long distance, where they can leverage their regulated local assets.



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Equity Research  
Broadcast - All Offices  
Code: A

Analyst: Frank J. Governali, CFA  
Industry: Telecom Services  
Telephone: (207) 780-6210  
Date: March 10, 1997

Industry: Telecom Services  
Subject: Meeting with FCC Staff & Chairman To Discuss Access Reform and Universal Service  
Ratings: No Change

### Summary

On May 8 the FCC must issue its order on Access Charge Reform and Universal Service funding. The FCC wants to keep the Street's expectations in line with reality, and to insure it is aware of expectations - thus meetings have been conducted with the Street. The FCC is not telling people what it intends to do, but rather reviewing the various options. Our meeting yesterday provided no basis to change our current view on access charge and universal service reform: we continue to believe that access reform will trim annual LEC revenues by \$5 to \$7 billion (net), by the end of a 3 to 5 year transition period. Universal service fund would be \$6 to \$8 billion. Reformed access charges will be comprised of fixed per-line charge, combined with usage sensitive fee.

- **Meeting with FCC Staffers with brief visit by Chairman Hundt.** Yesterday, February 26, we, along with four other sell-siders, met with FCC senior staffers and briefly with Chairman Reed Hundt. The avowed purpose of the meeting was to gauge the expectation of Wall Street to various policy options in the FCC arsenal regarding access reform and universal service. The FCC has been holding these meetings, and will hold others, to ensure it is adequately considering all options in its policy development, and to insure the Street is not in left field as it relates to expected outcomes. This is a smart move by the FCC, of course assuming, federal policy is not being dictated by stock prices - which of course it is not. By May 8 the FCC is required to come up with its order on access charge reform and universal service funding. The task is daunting and the implications profound for the industry. These issues get at the very heart of U.S. telecom policy and will be two of the prime determinants of whether or not competition successfully enters the local arena. (The others are the interconnect rules and the timing of RBOC entry into long distance.)
- **Hundt Lays Out Policy Principles In Presentation to NARUC On February 25.** On Tuesday Chairman Hundt presented an outline of policy priorities and principles to the National Association of Regulated Utility Commissioners. It is useful to consider his points, because it was this speech that was the backdrop for our discussion with the FCC officials on Wednesday. First, Hundt reinforced the notion that access charges need to get down to forward looking costs. Second, that the recovery of costs had to be done on a basis that encouraged competition and reflected the economic incurrence of cost. Thus, he supported the joint Board recommendation to collect access on both a fixed and variable basis - a fixed monthly per line charge combined with a lower usage element. Third, he reconfirmed his position that the LECs should not be assured of fully recovering historic costs in access reform or interconnection. Fourth, he reconfirmed his commitment to a transitional implementation of reduced access charges (not a dislocating flash cut).
- **No suggestion of revenue neutral reform of access charges.** Recently there have been stories circulating that access reform will end up being a "revenue-neutral" transition for the LECs. We definitely did not hear this yesterday. There can be several interpretations of what revenue neutral means. By our definition, it means that access charges themselves are changed in such a way as to not effect the net revenue collected for access. Thus, based on our discussion yesterday, we continue to believe that access charges will be cut, producing a net reduction in revenue to the LECs on an annual basis of \$5 to \$7 billion by the end of a three to five year transition period. We expect the 1997 cut, and subsequent additional cuts to total \$1 to \$2 billion, adding up to the total \$5 to \$7 billion.

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